In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-372

ROAD MATERIALS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The *per curiam* opinion of the court of appeals (Pet. App. B) is not yet reported. The findings of fact and opinion of the United States Tax Court (Pet. App. A) are reported at 30 T.C.M. 728.

JURISDICTION

The judgment of the court of appeals was entered on April 4, 1972. (Pet. App. B.) By order dated June 30, 1972, Mr. Chief Justice Burger extended the time for filing a petition for a writ of certiorari to and including September 1, 1972. (Pet. 2.) The petition was filed

September 1, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly held that petitioner did not directly own at least 95 percent of each class of stock of another corporation to which it had made advances, and that, consequently, petitioner's losses did not qualify for an ordinary loss deduction under Section 165(g)(3) of the Internal Revenue Code of 1954.

STATUTE AND REGULATIONS INVOLVED

Section 165(g) of the Internal Revenue Code of 1954 (26 U.S.C., 1964 ed.) and the pertinent provisions of Section 1.165-5 of the Treasury Regulations on Income Tax (1954 Code) are set forth at Pet. App. C.

STATEMENT

Petitioner, a corporation primarily engaged in the laying of stone base and asphaltic concrete, was owned by C. N. Haynes, Hazel S. Haynes, and A. C. Haynes (Pet. 6, 7), who were also the principal owners of Haynes Construction Company, Inc. (Haynes), a corporation engaged primarily in the grading of roads and laying of concrete (Pet. 6-8). Haynes employed Haskell Savage as its general superintendent in charge of heavy construction work. Savage proved to be such a valuable employee to Haynes that C. N. Haynes and the other members of the family owning stock became concerned that Haskell Savage might seek employment with another construction corporation unless he were given part ownership of the business. (Pet. App. A, p. 4a.)

Because of the limited funds available to Haskell Savage for investment, it was impossible for him to acquire an equity in Haynes large enough to serve as an incentive to remain with that company. (Pet. App. A, p. 4a.) Consequently, after some discussion between C. N. Haynes and Haskell Savage, it was agreed that the latter was to have a 35-percent stock interest in a new corporation, Savage Construction Company, Inc. (Savage). Savage, which was formed on March 3, 1960 (Pet. App. A, p. 4a), had one class of stock of 5,000 shares authorized at a par value of $10 per share (Pet. 9; Pet. App. A, p. 4a). Only 1,000 shares were issued for cash. Haskell Savage received 35 percent of the issued stock, and the remaining stock was acquired by the members of the Haynes family and business associates. (Pet. 9; Pet. App. A, p. 5a.)

C. N. Haynes arranged for petitioner to advance to Savage the $497,265.83 involved here, without security and without the execution of a note or other written evidence of indebtedness. (Pet. 9, 11; Pet. App. A, p. 5a.) These advances were carried on petitioner's books as loans and were entered on Savage's books as items payable by it. (Pet. App. A, p. 5a.) Despite the way these advances were carried on the books, there was never any agreement between Savage and petitioner to repay any of the advances within a specific or reasonable time, nor was there ever any demand for interest or repayment of principal, and none was paid. (Pet. 11; Pet. App. A, p. 5a.)

In a prior proceeding, the Tax Court held that the advances did not constitute a debt within the meaning of Section 166(a)(1) of the Internal Revenue Code.

Road Materials, Inc. v. *Commissioner*, 26 T.C.M. 922. The Fourth Circuit upheld this determination, but remanded the case to the Tax Court to determine whether the loss was deductible as an ordinary loss under Section 165(g)(3), which permits an ordinary loss deduction for worthless securities in an affiliated corporation, defined at that time (see *infra*, n. 1), as a corporation in which the taxpayer owned at least 95 percent of each class of stock. *Road Materials, Inc.* v. *Commissioner*, 407 F. 2d 1121 (C.A. 4). On remand, the Tax Court found that the loss did not qualify as an ordinary loss on the ground that petitioner did not own, or have a right to receive, the prescribed 95 percent of each class of stock of Savage and, therefore, that Savage was not an affiliated corporation under Section 165(g)(3). The court of appeals affirmed *per curiam*.

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other reason for further review.

1. Generally, the loss from securities becoming worthless within a taxable year is treated as a capital loss. Section 165(g)(3), as it was in effect for the year in issue,[1] carved out an exception to this general rule by permitting a corporation an ordinary loss with respect to a security in another corporation of which it owned

[1] Section 165(g)(3)(A) was amended by the Act of January 12, 1971, P.L. 91-687, 84 Stat. 2071, for taxable years beginning on or after January 1, 1970, and now provides for an ordinary loss to a corporation with respect to a security in another corporation of which it directly owns at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock.

at least 95 percent of each class of stock. See *Northeastern Consolidated Co.* v. *United States,* 406 F. 2d 76 (C.A. 7). The legislative history indicates that Congress intended Section 165(g)(3) and its predecessor to provide relief when certain very specific requirements were met. See S. Rep. No. 1631, 77th Cong., 2d Sess., p. 89; H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 21, A47; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 24. As found by both courts below, however, petitioner failed to meet the requirement of Section 165(g)(3)(A) that it own "at least 95 percent of each class of (Savage's) stock * * * ." Of the 5,000 shares of stock authorized by the certificate of incorporation, 1,000 shares were paid for and issued to persons other than petitioner. Therefore, petitioner did not own 95 percent of each class of stock as required by Section 165(g)(3)(A). *Northeastern Consolidated Co.* v. *United States, supra.* Even assuming, *arguendo,* as petitioner claims, that the advances were conditioned on the right to acquire all of the unissued stock of Savage, 20 percent had been issued to persons other than petitioner, and petitioner fell short of meeting the statutory requirement then in effect that it own 95 percent of each class of Savage's stock.[2] (Pet. App. A, p. 11a.)

2. Petitioner also contends (Pet. 17) that the decision below is inconsistent with decisions construing an analogous provision defining subchapter S "Small Business Corporations" (Section 1371 of the Internal Reve-

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[2] Petitioner appears to assume that stock ownership is measured in terms of the amount of money advanced. Section 165(g)(3)(A), however, refers to percentage of stock owned, not to the amount of value contributed.

nue Code).[3] In *Portage Plastics Co.* v. *United States*, 72-2 U.S.T.C., par. 9567 (C.A. 7, July 18, 1972), the only court of appeals which has ruled on this issue held that similar advances purporting to be debt but actually equity were a second class of stock for purposes of subchapter S. This is consistent with the decision in *Northeastern Consolidated Co.* v. *United States*, *supra*, applying Section 165(g)(3)(A), that advances which are an equity interest, although not common stock, constitute a second class of stock. In any event, this argument does not help petitioner, for even if it is deemed here to own a second class of stock, petitioner does not qualify for ordinary loss treatment under Section 165(g)(3)(A), since it did not own 95 percent of *each class* of Savage's stock.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[3] *Gussow, Kahn & Co.* v. *Commissioner*, 13 T.C. 580, acquiescence, 1950-1 Cum. Bull. 3, on which petitioner relies, was persuasively distinguished by the Tax Court. (Pet. App. A, pp. 9a-10a.) In any event, a decision here inconsistent with a Tax Court case is not such a conflict as would warrant certiorari.

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